



Wasatch Emerging Markets Small Cap Fund (WAEMX)

Quarterly Comments from Lead Portfolio Manager Roger Edgley, CFA,
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Associate Portfolio Manager Scott Thomas, CFA, CPA

Closed to new investors.

Open to existing direct shareholders and intermediaries with an established position.

Average Annual Total Returns For Periods Ended September 30, 2015

	Quarter*	1 Year	3 Years	5 Years	Since Inception**
Emerging Markets Small Cap Fund	-13.09%	-12.65%	-2.60%	0.73%	2.72%
MSCI Emerging Markets Small Cap Index[†]	-16.67%	-15.23%	-1.09%	-2.43%	-1.06%
MSCI Emerging Markets Index[†]	-17.90%	-19.28%	-5.27%	-3.58%	-2.80%

*Returns less than one year are not annualized.

**Return since the Emerging Markets Small Cap Fund's inception on 10/1/2007.

Data show past performance, which is not indicative of future performance. Current performance may be lower or higher than the data quoted. To obtain the most recent month-end performance data available, please visit www.WasatchFunds.com. The Advisor may absorb certain Fund expenses, without which total return would have been lower. Investment returns and principal value will fluctuate and shares, when redeemed, may be worth more or less than their original cost. **Total Expense Ratio: Gross: 2.02% / Net: 1.95%**

Total Annual Fund Operating Expenses include operating expenses, including the management fee, before any expense reimbursements by the Advisor. **The Advisor has contractually agreed to limit certain expenses to 1.95% until at least 1/31/2016.** See the prospectus for additional information regarding Fund expenses.

Wasatch Funds will deduct a 2.00% redemption proceeds fee on Fund shares held 60 days or less. Performance data does not reflect the deduction of fees or taxes, which if reflected, would reduce the performance quoted. For more complete information including charges, risks and expenses, read the prospectus carefully.

Investing in foreign securities, especially in emerging markets, entails special risks, such as currency fluctuations and political uncertainties, which are described in more detail in the prospectus. Investing in small cap funds will be more volatile and loss of principal could be greater than investing in large cap or more diversified funds.

This must be accompanied or preceded by a prospectus. Click [here](#) for a prospectus. Please read it carefully before investing.

Overview

In the third quarter, the Wasatch Emerging Markets Small Cap Fund declined -13.09%, but outperformed its benchmark, the MSCI Emerging Markets Small Cap Index, which decreased -16.67%. This has been one of the most difficult periods for emerging markets we can think of. Perceptions of the challenges within emerging markets (both political and economic) have clearly caused broad outflows in bonds and equities, and have caused investors to question the whole basis for emerging markets as an asset class. Sentiment has been exceptionally poor. On the questioning of emerging markets as an asset class, the classification brackets are subject to change and the logic can be questioned. However, emerging markets are still a huge chunk of the world's economy and population.

Growth and expectations for emerging markets have a lot to do with expectations for China

One of the useful precedents for understanding China going forward may be to look at Japan. We see many interesting parallels between the two countries that may offer insights into the possible financial unfolding of China over the next two decades. We do want not to get too invested in the belief that China is very similar to Japan, just that we believe there are insights to be gained. We want to be fox-like in making this comparison and not get too hedgehog-like.

It is worth doing a quick recap on Japan's financial history since 1980. From 1980 through 1989, the Nikkei 225 Stock Index (Nikkei)^{††} was up nearly six-fold. The Nikkei peaked in 1989 at close to 39,000 and over the next 20 years descended to 7,000 in 2008 (in yen terms). Results for U.S. dollar-based investors were not quite as bad, as the yen strengthened, so the low point was 2003 (the Nikkei in U.S. dollar terms went from 271 in 1989 to 66 in 2003). Still, this was a huge descent for an equity market. Even today, the Nikkei is only at about 18,000 so it never regained its height reached almost two decades ago. It is hard to believe, but the yield on the 10-year Japanese government bond hit 8% in 1990 and then descended a steep slope to hit 0.6% in 2003. The 10-year government bond bounced back into the territory of around 1.5% for a few years and then started another descent around the time of the Global Financial Crisis.^{†††} As of

September 30, 2015, the yield on the 10-year Japanese government bond stood at 0.36%. For the period from 1980 through 1990, Japan's gross domestic product (GDP)[‡] growth had been mainly in the 4% to 5% range. In prior decades, it was even higher than that.

Japan has been through decades now of disinflation, deflation and low GDP growth

Following are some comparisons between Japan and China. Both countries saw a real slowdown of GDP growth (China now and Japan in the 1990s) from previously torrid rates of growth. The problem with high GDP growth is that it is not necessarily *high quality* GDP growth. Imbalances were building up, including distortions in capital allocation and irrational behavior from corporate executives obsessed with market share rather than profitability. In Japan's case, these warped attributes of the economy underwent a long-term unwinding. A long-term unwinding in China is probably going to take place. In fact, we believe the process has already started. China's GDP growth rate has been reported at 7% year-over-year, which is slower than previous years. In our opinion, a good portion of China's GDP growth is low quality.

One of the quality attributes we look for in companies, which can also be applied to countries, is reasonable asset growth, not high asset growth. (We have taken note of academic studies looking at why companies with high asset growth underperform.) High asset growth carries too many risks. It usually strains the operational and management capabilities of a firm, increases leverage, stretches working capital and leads to lower returns on assets^{‡‡} and so on. Acquisitions can also be a risky part of high asset growth. Companies growing their balance sheets too fast can lead to blowup risk or painful corrections. Similar risks can also be seen in countries that grow too fast (although GDP is more a description of a country's income statement). China's high investment has led to high asset growth. If leverage is used to build assets that are then not used efficiently, a type of misallocation of capital occurs. (We built it and they never came!) Both Japan and China (and we saw the same thing in Taiwan and Korea in earlier decades) have gone through these phases. China, though, is having both massive demand and supply impacts on the world economy.

We can compare some of the economic similarities between China and Japan. Japan's bank loans as a percentage of GDP peaked at about 113% around 1993 (and they have come down since). China's bank loans as a percentage of GDP were close to 130% in 2015. The picture on investment is an interesting one. Japan's investment as a percentage of GDP peaked at around 32% in 1992 and declined thereafter (nominally and as a percentage of GDP). And now is in the

mid-20% range. China's investment as a percentage of GDP has been consistently a few notches higher than Japan's (in the high-40% range). So the idea that—like Japan's—China's investment to GDP can decline nominally and as a percentage of GDP makes sense, especially since it has been exceptionally high compared to any country. As rebalancing occurs away from investment to consumption, we may still see modest consumption growth as a percentage of GDP (which is what happened in Japan). With an unwinding economy (and an unwinding wealth effect), one cannot expect to see strong consumption growth (employment growth and incomes usually slow in parallel).

For China, consumer spending is around 37% of GDP (with investment at 47%). This gap will likely close quite a bit in the next 10 years, a good part of which will likely be driven by a fall in investment. In the last year in China, we have seen slower consumption growth as evidenced by retail sales numbers. Therefore, closing the gap will not be driven by strong consumption growth, but by a fall in investment. The consumer will not be feeling particularly optimistic in the likely coming environment. Even though China has the scope to lower interest rates, the amount of leverage in the system means that investment and growth will probably fall rather than increase.

With Japan's unwinding, we saw business confidence fall over a long period (tied to the strong yen and falling investment). Business confidence in China also has been falling as seen in poorer Purchasing Manufacturer's Index (PMI)^{†††} data. Corporate earnings fell in Japan over a long period in contrast to the prior growth years. Overall, forces in an unwinding period are deflationary and interest rates go to historically low levels. One of the compelling pieces of data is that through August 2015, China's Producer Price Index (PPI)[§] had declined for some 42 consecutive months.

When one visits Japan, it comes across as a well-managed country with great infrastructure. People are well-dressed and polite. It is a wonderful country to travel in. There have been positives from unwinding the excesses of the growth years—the constant pursuit of growth does not automatically lead to higher quality of life. And, there have been negatives, especially for savers and pensioners. If we assume the lessons to be learned from Japan will help us understand China, then these may include the changes mentioned above. In addition, we may see equity rallies that do not presage a reversal of the unwinding and that companies' earnings growth^{§§} may be disappointing. China, like Japan, does not have an external liabilities problem, so we will not likely see a financial crisis. In addition, we will not likely see a currency crisis, given China's reserves.

If the picture we have painted is a probable or comparable one, then we believe China's unwinding process may take place over many years. From an investment point of view, it will in aggregate be difficult to see growth for equities. Nevertheless, we expect to find some areas of opportunity. Capital will become tight, even with lower rates. That China is unlikely to have a financial crisis might be regarded as a positive, especially for China and for Asia as a whole.

Details of the Quarter

While China continues to dominate the conversation in emerging markets, there are interesting developments in other markets as well, and we are finding many attractive opportunities. However, we believe opportunities in emerging markets have narrowed—with the best opportunities being in places like India, Korea, Mexico and Taiwan, where the political and macro environments are fairly good and the economies are not overly dependent on commodity exports.

Returns from the Fund's holdings in India were positive on average and they outperformed the benchmark's holdings, which were down roughly -2%. India is one of the fastest-growing economies in the world. It also has a long history of democracy and the rule of law and a strong regulatory environment. Further, a long history of corporate formation and entrepreneurship has created a pool of talented managers. Currently, we view India as one of the most attractive of the emerging markets. India's economy and financial markets are well-positioned and the reforms and new initiatives taking place under Prime Minister Narendra Modi seem to be positive. As a significant importer of oil, India stands to benefit from the lower price of crude. In addition, we believe favorable demographics and an expanding middle class will likely drive increasing consumer demand. Lower inflation should also contribute to currency stability.

The number of interesting and high-quality potential investments in India is broad based. Wasatch's investment team has been investing in India for over 10 years. On average, team members visit India two times per year and meet approximately 50 companies each visit. As a result, the Fund has been and we expect will continue to be overweight relative to the Index. Seven of the Fund's top 10 contributors for the quarter were from India, with **Marksans Pharma Ltd.** being the Fund's top overall contributor. This Indian drug maker exports its products to the U.S., Europe, Southeast Asia and other international markets. The company is one of only a few in India with the technology to manufacture the soft-gelatin capsules

commonly known as softgels or liquid gels. Marksans is benefiting from its new-product offerings, as well as from increased consumer demand for softgel formulations.

Korea is another market where we believe we can find attractive small-cap investments in the current environment. While performance was weak in the third quarter, the Fund was underweight versus the benchmark and the Fund's holdings outperformed, adding nicely to performance relative to the Index. Korea has a supportive macro environment with moderate GDP growth, a strong current-account position, currency stability versus the U.S. dollar, and a central bank that has provided stimulus to the economy. Corporate governance is improving and a next generation of entrepreneurs has created a new class of companies. This is particularly evident in health care, e-commerce and technology. Companies are increasingly focusing on returns on capital^{§§§} and becoming more shareholder-friendly. We have been increasing our position in Korea over the past year. **Interpark Holdings Corp.**, which operates an Internet-based shopping mall, and **BGF Retail Co. Ltd.**, a franchise retail-store operator, were two of the Fund's top 10 contributors for the quarter. **Medy-Tox, Inc.** was one of the largest detractors for the quarter. We've written repeatedly about this company in past reports, as it has been a top contributor. The company develops biopharmaceuticals for cosmetic applications and the treatment of muscular disorders. For much of the year prior to September, the company's stock had soared on optimism that its second-generation botulinum toxin may offer an attractive alternative to BOTOX[®] Cosmetic for reducing wrinkles and aging of the face. We believe that this recent reversal in performance was merely market movement and that the company has an attractive long-term investment profile.

We have spent and will continue to spend time in China, and we have visited many Chinese companies. We have had challenges finding companies that meet our investment criteria. As a result, we're comfortable with a portfolio weighting in China below the benchmark weighting. Our underweighting added substantially to relative performance during the third quarter. The Fund was roughly half the weighting of the benchmark, which was at approximately 20%. Stocks in the Fund and the benchmark were down about 27% on average. This resulted in nearly three percentage points of relative outperformance for the Fund. *(Current and future holdings are subject to risk.)*

Outlook

We expect weak commodity prices and difficult political situations to pose additional challenges for a number of emerging markets, including Brazil, Indonesia, Russia, South Africa and Turkey.

The Fund currently holds no investments in Russia, and we've recently reduced exposure to each of the other countries mentioned.

As we have said, we see a “narrowing” of the investable markets we believe are attractive in emerging markets. However, we are finding many companies with attractive stock valuations.[#] Given the relatively full valuations around the world, we believe companies with the best prospects for top-line and bottom-line growth are the most likely to be rewarded in the stock market. If we choose individual companies and countries correctly, we believe we can structure a sound and well-diversified Fund, even within a narrower set of countries. Our outlook is brighter for India, Korea, Taiwan and Mexico. We believe favorable demographics and expanding middle classes are likely to drive increasing consumer demand in each of these countries.

We thank our shareholders for their support through a difficult period.

Sincerely,

Roger Edgley, Andrey Kutuzov and Scott Thomas

Note: We are indebted to research by Cornerstone Macro, especially “*China’s Great Unwind: Lessons from 1990s Japan*,” April 28, 2015.

[†]The MSCI Emerging Markets and Emerging Markets Small Cap Indices are free float-adjusted market capitalization indices designed to measure the equity market performance of emerging markets. You cannot invest in these or any indices.

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The Wasatch Emerging Markets Small Cap Fund’s investment objective is long-term growth of capital.

^{††}The Nikkei 225 Stock Index is a price-weighted index of the 225 top Japanese companies (called the First Section) that are listed on the Tokyo Stock Exchange (TSE).

^{†††}The financial crisis of 2007-08, also known as the Global Financial Crisis and 2008 financial crisis, is considered by many economists to have been the worst financial crisis since the Great Depression of the 1930s.

^{*}Gross domestic product (GDP) is a basic measure of a country's economic performance and is the market value of all final goods and services made within the borders of a country in a year.

^{††}Return on assets (ROA) measures a company's profitability by showing how many dollars of earnings a company derives from each dollar of assets it controls.

^{†††}The Purchasing Managers Index (PMI) is an indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators—new orders, inventory levels, production, supplier deliveries, and the employment environment.

[§]The Producer Price Index (PPI) is a weighted index of prices measured at the wholesale, or producer level. The PPI shows trends within the wholesale markets, manufacturing industries and commodities markets.

^{§§}Earnings growth is a measure of growth in a company's net income over a specific period, often one year.

^{§§§}Return on capital is a measure of how effectively a company uses the money, owned or borrowed, that has been invested in its operations.

[#]Valuation is the process of determining the current worth of an asset or company.

Emerging Markets Small Cap Fund Top 10 Holdings as of June 30, 2015^{##}	Percent of Net Assets
Hermes Microvision, Inc. (Taiwan)	1.6%
Security Bank Corp. (Philippines)	1.6%
Hanssem Co. Ltd. (Korea)	1.6%
Poya Co. Ltd. (Taiwan)	1.6%
Medy-Tox, Inc. (Korea)	1.5%
International Container Terminal Services, Inc. (Philippines)	1.5%
D&L Industries, Inc. (Philippines)	1.5%
Grupo Aeroportuario del Centro Norte S.A.B. de C.V. (Mexico)	1.4%
BGF Retail Co. Ltd. (Korea)	1.4%
Minor International Public Co. Ltd. (Thailand)	1.4%
Total	15.1%

^{##}Portfolio holdings are subject to change at any time. References to specific securities should not be construed as recommendations by the Fund or its Advisor. Current and future holdings are subject to risk.

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